

Financial Lessons From TFL



In his first post of 2012, Hemant had asked the readers to share what they had learnt from TFL in 2011, I have penned down some Financial Lessons which I have received from TFL during 2011, which will hopefully last a lifetime.

Anil Kumar Kapila

Anil Kumar Kapila



“The satisfaction you get in giving something useful to someone is far greater than in getting something from someone.”

The Financial Literates
www.TFLGuide.com

Establish a regular savings habit



Everyone's investment path starts with savings. There are no hard and fast rules for saving. It certainly depends on your personal economic conditions, your temperament and of course on the unsuspected demands that inevitably arise. How much you save depends on your age and family situation.

How much you save depends on how much you earn, and of course this changes throughout your life. It is important to establish a regular saving habit for your own financial health.

Savings are initially the basic component of your wealth. After a number of years your wealth will grow from the interest on your savings and the growth of your investments.

Saving is not enough



It is a profound mistake to assume that conservation of wealth means putting money in the most secure instrument. Protection of funds in the most conservative way can prove to be disastrous in the long term due to inflation.

Locking funds in low interest bank deposits defeats the purpose of creating wealth. Inflation does its secret work by devaluing your purchasing power when you are not looking. The total avoidance of risk earlier in life guarantees a loss of real buying power later.

Riskless investors may feel better by remaining away from the volatility of the financial markets, but over the long haul their savings and assets invisibly erode.

Be a long term investor

It is important for investors to take long term perspective in dealing with financial matters. It is counterproductive to worry over the daily ups and downs of the stock exchanges. Solid gains in the financial world are almost always associated with holding long term positions. The idea is to create wealth slowly, but surely.

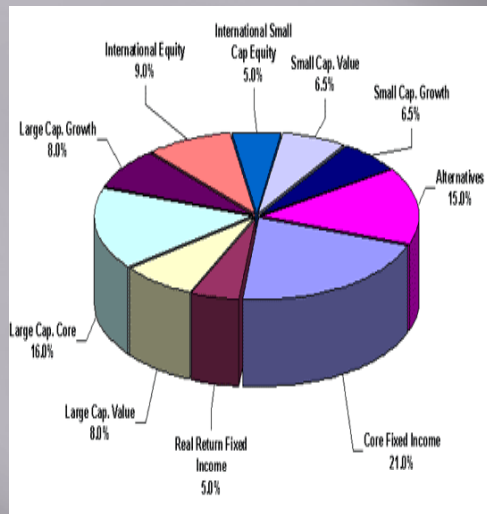
Successful investing is a long range endeavor. If you expect immediate results and instant gratification, you are by temperament not suited to long term investments. Investing is a waiting game, one in which you will need more patience than money if you are to be successful.



Prepare an inventory of assets

- ✓ How much you can afford to invest depends on your capital, your earnings, your expenses, your responsibilities and so on. Before calculating how much to invest, it is important to assess what you have that can be best deployed.
- ✓ Your net worth statement is your first step on the road of financial planning. This statement is a listing of everything you own against a list of everything you owe. The balance what remains is your net worth.
- ✓ Your net worth statement provides a benchmark to measure progress or slippage in your net worth. It indicates how your assets are presently allocated. This provides a platform upon which a better financial plan can be built.

Asset Allocation



There is no ideal model of asset allocation for all situations. While reallocating assets age and income must be given proper weight. It is important to remember that you do not overweigh one asset class to the possible detriment of others.

Having all your eggs in one basket, no matter how strong the basket is or how carefully you watch it like a hawk is not a good investment strategy. It can prove to be a costly mistake in the long run. Beware of a situation where your basket topples, your eggs break and you are left with egg on your face.

One important goal of your asset allocation is to temper your vulnerability. Hence it is prudent to diversify your assets.

Asset allocation is a simple way to reduce your risk by spreading investments across different asset classes. It is also about spreading your investments over time while factoring in your financial requirements. Cont...

Asset Allocation Cont..

Asset allocation is based on the fact that different asset classes tend to behave differently. While equity is volatile in the short term, over the long term it delivers the highest returns among all asset classes. Debt instruments on the other hand are very stable but they cannot beat inflation over the long term. A combination of these two asset classes can give us the best of both worlds.

Asset allocation helps in avoiding efforts to time the market. Financial markets are impossible to predict. One cannot say which asset class will perform when. The best thing to do is to be prepared by allocating between assets with different risk return characteristics.

A prudent approach is not necessarily ultraconservative, but it is one that recognizes definable risk and plans to take advantage of that. There are times to be aggressive and times to be cautious. Your asset allocation is forever changing, partially because of financial stages and partially because of the changing economic environment. Prudence means acting on reasonable expectations that allow for building of a diversified portfolio consisting for both fixed income and equity. You can then have best of both worlds.

Keep it simple

Buy a bond fund for fixed income and diversified equity fund for equity. These are the basics of the investment world and you cannot go wrong with these.

Ignore exotic funds

Sector funds are risky. You should not be investing in exotic funds unless you have a huge risk appetite.

Start early

Power of compounding will turn things in your favor in the long term provided you start early.

Have a financial plan

An investment plan can help increase the value of savings faster if undertaken early and pursued consistently. Growth of assets will then sharply reduce the time it takes to gather a nest egg for retirement.

The purpose of saving and investing is not to make you wealthy in the short term but to create wealth in a slow but sure manner.

It is shortsighted to start investing without substantial money in the bank, funds that you will not touch in the most dire circumstances.

The one place where it is possible to increase the return on your investment at an average rate that historically surpasses interest rates paid by fixed income instruments is in equity.

Investing in equity is the only way to achieve real growth. The one constant we can all be sure of is inflation. Thus the money invested in debt is being constantly eroded in terms of its purchasing power.

For meeting your short term objectives invest in fixed income instruments. For meeting long term goals consider equity investment.

The risks of investing

There are, to be sure, some risks in investing. If witnessing the contracting and expanding of your investments has a depressing affect on you, perhaps you should not be directly involved with the stock markets. Instead, consider less volatile vehicles, such as mutual funds. There is no reason to participate in an activity that causes anxiety and may not be good for your health. Mutual fund investors can still benefit from the investment process without exposing themselves to undue risks.

Measure your risk tolerance

You have to decide which risk personality fits your best. Are you risk averse? Are you risk neutral? Are you risk lover? If you are totally risk averse, stay away from the investment world. If you are risk neutral, the investment world should pose no problem to you. You have a wide variety of investment vehicles to choose from that will provide safety and diversification. Risk lovers can range over the whole investment world.

Before making any investments in mutual funds you must do a risk tolerance test for yourself. Try to find out how much risk you can handle. You should know that all mutual fund investments are subject to market risks. There is a strong possibility of the value of your investment going down immediately after your investment in the short term. If you cannot bear to see your investment losing its value any time then investment in aggressive equity mutual funds is not for you.

Stay away from a complex financial instrument

Investors have a vast department store in which to shop. The menu is virtually endless, and your choices are limited only by your effort and imagination in the decision making process.

The financial world is constantly changing and will continue to do so. New products are created almost daily, and not all of them are useful for you. A prudent investor will wait until a new complex financial instrument has proved itself in the marketplace. Beware of a new financial product that claims to solve your all financial problems.

Have a contingency fund

Most people are not psychologically ready to invest until they feel financially secure. Security for most people is sufficient money in the bank. Under normal circumstances you should not seriously consider investing unless you have accumulated funds roughly equal to one year's income in the bank.

Some people are in the habit of leaving an incredible amount of funds in their savings bank account. Leaving excessive amount of cash in the savings account is not needed. Cash to cover three to six months' living expense is suitable for most people.

Should you use credit?

Those people, who worry too much, must normally avoid any form of credit. Some people simply do not know how to use credit properly. It is better for such people to always remain away from credit.

Credit if not abused can be of great use. But it must be controlled and constantly monitored.

The decision to use credit depends both on financial as well as psychological factors. One who takes on too much credit does so at his/her own peril. It is normally not prudent to get credit of more than 25% of your net worth.

Time frame of investing

Before starting your investments, it helps to know what your time frame is. Are you investing for your short term, medium term or long term objectives? In the investment world, short term investments start tomorrow and last upto two years, medium term investments are those between two and five years and long term investments are those which are made for more than five years.



Understand your goals of investing

Understanding your objectives and your own nature plays a large part in successful investing. Many investors face great difficulty in matching their investments with their objectives.

There are two general goals for investors to pursue-income and growth. These goals are conditioned by such factors as safety and diversification. Investment objective are few, but the investment world is enormous.

Some investors invest to get a regular income. Income is the return you get from invested funds. Income is derived from dividend or interest. The other reason for investing is appreciation of capital that is, seeing your money grow.

Spread your risk by diversification



In financial matters it is prudent to protect yourself by having a diversified portfolio of investments. Diversification is an attempt to deal with the problem of market timing. Averaging is a reasonable formula, a trade off with market realities. By constantly investing fixed amounts at regular intervals over a long time, you can minimize the effects of fluctuations of markets.

In the case of mutual fund investments, it is preferable to go for investments in diversified equity funds or balanced funds. Investing in sector funds or thematic funds can be risky due to inadequate diversification. Apart from selecting funds having diversification across market caps, it is also important to have diversification across fund houses. SIP route of investing provides time diversification by investing across different market cycles.

Profit from uncertainty



You have to realize that fluctuations are part and parcel of the investment process. They are not necessarily a threat to the safety of your investments. The financial world may offer you potential rewards for tolerating some uncertainty.



Portfolio at Retirement

Some people are of the view that at retirement your portfolio should consist of only fixed income instruments. This is clearly not a correct approach. Minimum 20% allocation to equity is a must in the portfolio of retired persons.

The combination of longer life expectancy and constant inflation argues for a portfolio with a continued commitment to equity along with fixed income. Your assets should always contain some elements of appreciation since you can never be certain about what unexpected expenses you might face.

The only way you can hope to offset the erosion of your wealth is by continuing to invest a portion of your portfolio in equity mutual funds.

Mutual fund investing



Mutual funds are best suited to investors who do not want to commit a great deal of time and money to the stock markets.

They offer professional management relatively cheaply to small investors.

They serve the purpose of safety through diversity and expert management.

A mutual fund is a very useful investment vehicle of the small investor.

Benefits of mutual fund investing

Mutual funds are affordable for everyone. Even a small investor can buy mutual funds by investing a small amount at a time.

By buying a mutual fund you obtain the services of a professional fund manager to manage your money for a very small fee. With a small investment you can buy the stocks of several top companies, which may not be possible for you to do as an individual investor.

Thus by investing in mutual funds you are able to get the benefit of diversification by spreading your risk across different stocks. Investments in mutual funds provide you liquidity and are tax efficient.



Have realistic expectations

In the short term you cannot expect to get large returns from your investments in equity mutual funds. Real growth of money takes place due to power of compounding only when you remain invested in equity mutual funds for a very long time. You have to set realistic expectations both for your goals as well as your returns.

Fund management



Fund house as well as fund manager play a crucial role in the long term performance of a fund. A fund house with a good pedigree will boast of a large number of highly performing funds. This is because a good fund house will have systems in place with a team of highly skilled and experienced fund managers. When a good fund house has systems in place, the performance of the funds depends more on the systems and less on the individual performance of a star fund manager.

Fund cost



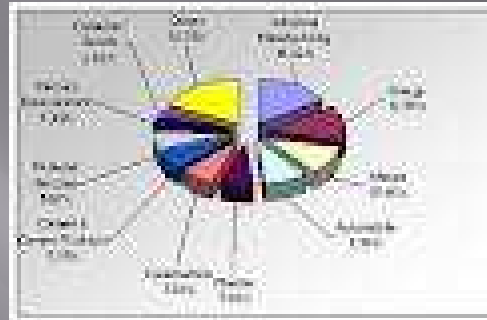
It may not be worth buying a higher cost fund that appears to be only slightly better than a lower cost one. There is no reason why a fund house should have higher costs than others. If a fund house has higher cost, then it must justify it by giving you higher returns on your investment.

Know your mutual funds

A large number of mutual funds are available from around forty mutual fund houses. Each mutual fund has a stated objective. Each mutual fund has some potential risk. You must spend some time for close understanding of the funds. This will help you to meaningfully diversify your mutual fund portfolio. Stated objective and risk profile of the funds selected must match with your objective and risk profile



What are sector weightings?



Mutual funds with large stakes in just a few sectors will likely be more volatile than the more evenly diversified funds. Look at the sectoral history of the fund to gain a good perspective.

What is fund's concentration?

A portfolio that puts most of its assets in just a few stocks will likely be more volatile than a fund that is spread across hundreds of stocks. But there could be rewards of concentration.

Check fund performance

Performance comparisons must be used only to compare the same type of fund. You have to compare apples with apples. You cannot compare apples with oranges.

Past performance of the fund is no indicator of future results. Do not focus on short term returns. Check long term performance of the fund across market cycles.

Check your portfolio

Your mutual fund portfolio must be properly diversified. A balance must be maintained across market caps like large cap, midcap and small cap. There should not be any over represented or under represented areas.

The key challenge in mutual fund investing is to choose the right funds to meet your objectives.

Core and satellite approach

The decision on which funds to invest in should be made in the context of your overall portfolio that should have core and satellite segments. The core will consist of anything between 60 to 80% depending on your risk appetite. The core will provide stability to your portfolio. It will mainly consist of large cap and large & midcap value funds. The core segment should be made of well diversified and more predictable funds that have a proven long term record of outperformance. Funds that rank in the top quartile consistently over time periods of one, three, five, seven, ten years would be good candidates. After identifying funds, ratings can be used as the final deciding factor.

The satellite portion of your portfolio could be made of well rated funds that show the promise of good performance in the future. It will consist of multi cap funds, mid & small cap growth funds, sector funds, and thematic funds. These funds are risky but have potential of high growth. The exposure to sector and thematic funds should be very low because of the high risk involved in these funds.

A small allocation to a sector oriented fund, a more flexible fund, or a more concentrated fund could boost your returns.

Have a Wonderful Financial Life



The Financial Literates
www.TFLGuide.com